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No. _____

In The

Supreme Court of the United States

BRIAN L. AND CAROLE J. NAHEY,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

As part of their acquisition of the business assets of an unrelated corporation, the taxpayer's "S" corporations acquired a pending dispute between the seller and a third party, consisting of both the seller's claim against the third party for profits the seller had allegedly lost because of the third party's actions, and a potential liability of the seller to the third party in connection with that same transaction. Subsequently, each of the taxpayer's corporations received a payment from the third party in settlement of the purchased claim. The question presented is:

> Is the payment received by the taxpayer's corporations in settlement of the purchased claim properly taxed to them:
>
> (a) as ordinary income because the origin of the claim was in the ordinary business activities of the original claimant, thereby ignoring the intervening capital acquisition in which the claim was acquired (as held by the court of appeals in this case), or
>
> (b) as long term capital gain, because the origin of the claim to the taxpayer's corporations was not in their ordinary business activities, but was rather in the intervening capital acquisition, and because (under long standing precedents) they would for that reason have been required to treat as a capital expenditure any payment that they might have been required to make to the third party in connection with the same dispute.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Brian L. and Carole J. Nahey respectfully petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App. 1a-15a) is reported at 196 F.3d 866. The opinion of the tax court (App. 17a-33a) is reported at 111 T.C. 256.

JURISDICTION

The court of appeals entered its judgment on November 17, 1999. A petition for rehearing was denied on January 28, 2000. App. 34a. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISION INVOLVED

I.R.C. § 1222 is reproduced in the appendix to this petition. App. 35a-36a.

STATEMENT

The Petitioners are husband and wife, residing in Hartland, Wisconsin. Mrs. Nahey is a party to this proceeding only because she filed a joint federal income tax return with her husband in 1992, and Mr. Nahey will be referred to as the "taxpayer." During 1992, the taxpayer was the principal shareholder of two "S" corporations, Venturedyne, Ltd. ("Venturedyne") and Carnes Company, Inc. ("Carnes"). Following an audit of the 1992 federal "S" corporation tax returns of the two corporations, the Respondent (the "Commissioner") determined that certain income received by the two corporations in 1992 should have been reported as ordinary income, and passed through as such to the taxpayer. This was contrary to the manner in which this income had been reported in the corporations' and taxpayer's tax returns as filed, where this income had been treated as a long-term capital gain. Consequently, on March 15, 1996, the Commissioner issued a Notice of Deficiency to the taxpayer (App. 37a) and, on April 30, 1996, the taxpayer filed a timely petition with the United States Tax Court. In a decision filed by the Tax Court on October 21, 1998 (App. 17a-33a), that court upheld the validity of the Commissioner's Notice of Deficiency, and the taxpayer filed a timely notice of appeal to the United States Court of Appeals for the Seventh Circuit. On November 17, 1999, the Court of Appeals issued its decision, affirming the Tax Court, with Chief Judge Posner writing the majority opinion. App. 1a-10a. Judge Cudahy filed a separate opinion, in which he disagreed with much of the majority's analysis, but ultimately concurred in its decision because of his deference to the Tax Court. App. 10a-15a. The taxpayer filed a

timely petition for rehearing and petition for rehearing en banc, but this was denied by the court of appeals on January 28, 2000. App. 34a.

The amounts in dispute consist of approximately $6 million that Carnes and Venturedyne received from Xerox Corporation ("Xerox") in 1992. These amounts were paid by Xerox in settlement of a lawsuit that Carnes and Venturedyne purchased in 1986 from an unrelated entity, Wehr Corporation ("Wehr"), as part of their acquisition of Wehr's assets. The background of that lawsuit, and its acquisition and ultimate resolution, are as follows:

Until the end of 1986, the taxpayer was president of Wehr, and a member of Wehr's Board of Directors. He owned about 10% of the shares of that corporation, the balance being held by various members of the Manegold family, to which the taxpayer was unrelated. Wehr manufactured and distributed a variety of industrial equipment and devices.

On December 31, 1983, Wehr contracted with Xerox for the installation and implementation of a computer system to unite all of Wehr's operational, managerial, and administrative functions. Wehr anticipated that the system would significantly increase its revenues, profits, and value. The installation was to be completed by the end of 1984 but, from the beginning, Xerox fell behind schedule. Wehr reacted by withholding payment of certain fees contractually owed to Xerox and, early in 1985, all work stopped. At the time, Wehr allegedly owed $652,984 to Xerox in fees.

On February 11, 1985, Wehr filed a lawsuit against Xerox in federal court, alleging breach of contract, intentional fraud and misrepresentation, and negligent misrepresentation. Although no specific amount of damages were stated, the complaint alleged that such damages exceeded $5 million. In its answer to the lawsuit, Xerox counterclaimed for the fees allegedly owed to it.

The lawsuit proceeded through 1985 and, in 1986, Xerox made a settlement offer to Wehr of up to $2 million. The taxpayer, as Wehr's President, rejected this offer. The taxpayer informed Wehr's Board of Directors about the settlement proposal, and told them he believed Wehr could ultimately recover as much as $10 million from Xerox.

During the fall of 1986, Robert Manegold, who was Chairman of the Board, contacted the taxpayer to inquire whether the taxpayer might be interested in buying Wehr. The taxpayer was interested, and entered into negotiations with a number of investment bankers to finance the acquisition. In these negotiations, the taxpayer discussed the pending lawsuit, and informed the bankers that he believed Wehr would ultimately receive between $2 million and $10 million from Xerox. Ultimately, the taxpayer decided not to utilize outside financing for the acquisition, and Mr. Manegold agreed to a leveraged buy-out ("LBO"), in which Wehr would accept the buyer's debt obligations in payment for its assets. In agreeing to this arrangement, the parties took into account the existence of the Xerox lawsuit as part of their financial analysis. The taxpayer thereupon caused two new "S" corporations to be formed, Venturedyne and Carnes, and, on December 30, 1986, Venturedyne purchased all of the assets and

assumed all of the liabilities of Wehr, other than those related to Wehr's Carnes Division, and Carnes purchased all of the assets and assumed all of the liabilities of the Carnes Division. The total purchase price was in excess of $100 million. Among the assets purchased and the liabilities assumed by Venturedyne and Carnes were all of the then-pending lawsuits by and against Wehr, including Wehr's lawsuit against Xerox and Xerox's counterclaim. The taxpayer owned in excess of 97% of the buying corporations, and he served as their chairman and chief executive officer.

Following the 1986 LBO, Wehr was liquidated, and the "S" corporations continued to operate the same businesses as had been operated by Wehr prior to the sale of its assets. They also continued the Xerox litigation.

Because the LBO acquisition agreement did not allocate the purchase price among the various Wehr assets, the taxpayer engaged two accounting firms to assist in the allocation process. The accounting firms initially believed that the value of the Xerox lawsuit was several million dollars, but they ultimately determined that the lawsuit was "too speculative" to value. Consequently, no portion of the LBO purchase price was allocated to the Xerox litigation, either for tax or financial accounting purposes. The audited financial statements of the corporations did, however, contain a footnote reference to the pending claim. On July 1, 1993, in resolution of a tax dispute unrelated to the instant case, the "S" corporations, the taxpayer, and the Commissioner executed a Closing Agreement, allocating the LBO purchase price among the purchased assets as of the initial date of the

acquisition for all tax purposes. No value was assigned by this Agreement to the Xerox lawsuit.

Following the LBO, the "S" corporations continued the lawsuit against Xerox for six years. Various issues surfaced during this period, including Xerox's contentions that the plaintiffs' potential recovery was significantly limited because of Wehr's alleged failure to mitigate its damages following the termination of the contract, and because of a Wisconsin legal doctrine that would have made it impossible for the plaintiffs to recover any of Wehr's allegedly lost profits for post-1985 periods in any event.

In 1992, the plaintiff corporations introduced into the lawsuit a different method of computing damages, resulting in a claim of up to $120 million and, after the District Court ruled that the plaintiffs would be able to introduce evidence on this method at trial, settlement discussions began in earnest. Initially, Xerox offered between $2 and $3 million to settle, but it ultimately raised its offer to $6 million. The taxpayer was initially reluctant to accept that amount, but his legal advisers informed him that, in their opinion, Xerox's defense against any liability for profits lost by Wehr after 1985 were extremely strong. Relying on this advice, and also giving significant weight to the deposition testimony of experts for both sides relating to the calculation of damages (which supported the advice that taxpayer was receiving from his lawyers on this subject), the taxpayer ultimately agreed to a settlement by which Xerox would pay $5,950,000 in cash and cancel its counterclaim, for a total of $6,345,183.

The settlement was allocated to Venturedyne in the amount of $3,502,541 and to Carnes in the amount of $2,842,183. Each corporation reported its share of the settlement as a long-term capital gain in 1992 and, because they were "S" corporations, this passed through as a long-term capital gain to the taxpayer in that year. In her Notice of Deficiency, the Commissioner determined that the entire settlement proceeds should have been taxed as ordinary income.

REASONS FOR GRANTING THE PETITION

I. INTRODUCTION

Chief Judge Posner, writing for the majority below, concludes that the Xerox settlement proceeds should be taxed as ordinary income to Venturedyne and Carnes, and therefore to the taxpayer, (a) because those proceeds would have been taxed as ordinary income *to Wehr Corporation* if they had been received thereby,[1] and (b) because that characterization necessarily determines the tax treatment of such amounts *to Wehr's successors*. Therefore, according to the majority, a corporate acquisition of a pending claim is "merely an intermediate transaction" that "should not affect the tax treatment" of the claim when later resolved by the acquirer. App. 7a-8a. Writing

[1] The taxpayer does not dispute this point, because the settlement proceeds would then have been received by Wehr as a substitute for its allegedly lost profits, and because those profits (if they had been earned) would of course have been taxed to Wehr as ordinary income. *Alexander v. IRS*, 72 F.3d 938, 942-44 (1st Cir. 1995).

separately, however, Judge Cudahy states that he has "substantial doubt" about the majority's conclusion, and that he "seriously question[s]" important aspects of the majority's analysis. *Id.* at 15a. Judge Cudahy also points out that the majority's opinion "ignores or excludes whole lines of authority."[2] *Id.* at 10a. Other commentators on the tax court and the court of appeals' decisions have been even more critical, referring to the decisions as "disturbing," difficult to follow, exalting form over substance, and "adding to the confusion,"[3] as well as being "problematic," inconsistent with "the overwhelming jurisprudence," a departure from "economic reality," and in conflict with the "origin of the claim" test,[4] a long-standing and well-accepted method of determining the tax character of litigation proceeds.

As Chief Judge Posner and Judge Cudahy acknowledge, the court of appeals' decision in this case is in *direct* conflict with at least one other court of appeals' decision, *Pacific Transport Co. v. Commissioner*, 483 F.2d 209 (9th Cir. 1973) (per curium). App. 8a-10a. In addition, although

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[2] Judge Cudahy nonetheless concurs in the conclusion reached by the majority because of his decision to defer to the Tax Court, "which deals regularly with the issues that trouble us." App. 15a.

[3] These conclusions and quotations are from Robert W. Wood, *Litigation Settlements: Are They Ordinary Income or Capital Gain?*, 86 Tax Notes 277 (2000). Mr. Wood is the author of the leading treatise on this subject, *Taxation of Damage Awards and Settlement Payments* (2d ed. 1998).

[4] These quotations are from Nicholas H. Schmelzer, *Tax Treatment of Commercial Litigation Income*, 84 Tax Notes 733 (1999), discussing the Tax Court's opinion below.

Chief Judge Posner attempts to distinguish the instant case from the decision of this Court in *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952) (App. 8a), Judge Cudahy recognizes that the "principles underlying *Arrowsmith*" (which he correctly understands to be the foundation for the taxpayer's arguments in this case) cannot be reconciled with the rule adopted here by the court of appeals. App. 10a, 13a. Rather than following these (and other precedents), however, the court of appeals chooses to embark on a search for a new rule that, according to Chief Judge Posner, will be "simple" and "neutral," in the sense of "not influencing business judgments." *Id.* at 7a. The result of this search is described above and discussed in more detail below but, even if it did achieve Chief Judge Posner's stated goals, his new rule simply ignores long-standing precedents that compel a different result. Further, as Judge Cudahy points out, the decision of the majority reflects an "unrealistic" hope that other courts will be so enamored by this new rule that they will follow it, "presumably in preference to their own precedents," and that the new approach will also be adopted by the government, even though that would likely cost the government substantial sums in lost tax revenues.[5] *Id.* at 11a.

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[5] The reason why the court of appeals' rule would lower the government's tax revenues if allowed to stand is that, as recognized by Chief Judge Posner (App. 8a-9a), the new rule would allow the purchaser of a business to deduct any payments made by it in satisfaction of a liability assumed as part of a purchase, as long as the payment would have been deductible if made instead by the acquired entity. This is directly contrary to the long-standing rule, reflected in such cases as *Pacific Transport*, 483 F.2d 209, that such liabilities are part of the purchaser's acquisition cost, and must be capitalized

In addition, the new rule is by no means as "simple" and "neutral" as Chief Judge Posner claims, and opens at least as many opportunities for aggressive tax planning as it purports to close. Finally, the court of appeals' approach conflicts with, or at least substantially limits, such other well-accepted tax doctrines as the "origin of the claim" rule of *United States v. Gilmore*, 372 U.S. 39 (1963), and the "open transaction" rule of *Burnet v. Logan*, 283 U.S. 404 (1931), and this Court's guidance is needed as to how these doctrines are to be applied where a taxpayer resolves a claim initially acquired by it in a capital transaction. For all these reasons, and because these important questions are present in virtually every corporate asset acquisition, the prompt resolution of these issues is crucial to the proper administration of the federal tax laws, and requires the prompt attention of this Court.

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when paid, that is, added to the basis of the acquired assets. Chief Judge Posner concludes in this case that, if *Pacific Transport* truly holds that these types of expenses are non-deductible (as it does hold), *Pacific Transport* is an "incorrect decision" (App. 9a) and has to yield to his "simple" and "neutral" rule that the initially deductible nature of a liability is not changed by an "intermediate" acquisition. In view of this decision, tax advisers in at least the Seventh Circuit would be remiss in not advising their acquisition-minded clients to deduct all such liabilities as a routine matter. It can reasonably be assumed that the tax revenues that would be lost by allowing all of these expenses to be deducted rather than capitalized would far exceed any tax revenues that would be gained by taxing all of this income as ordinary rather than capital.

II. THE COURT OF APPEALS' DECISION IS IN DIRECT CONFLICT WITH APPLICABLE PRECEDENTS.

Chief Judge Posner begins his opinion by stating that this case "presents a question that one might (wrongly) have supposed resolved long ere now. . . . " App. 1a. This is accurate in a narrow sense, but is wrong as a broader matter, as Chief Judge Posner later acknowledges. Viewed narrowly, then, this case is only about how the purchaser of a pending claim for monetary damages (that arose out of the business activities of the seller) is to treat payments later received from the defendant pursuant to a judgment or settlement of the purchased claim. It does appear that there are no relevant precedents dealing with this narrow question. As Chief Judge Posner and Judge Cudahy agree, however, this transaction presents a "mirror image" (*id.* at 13a) of a more common occurrence, that being where a taxpayer assumes, as part of a business acquisition, a disputed liability of the seller, and where the buyer is subsequently required to make a payment in satisfaction of that liability. As Judge Cudahy states, it is fair and logical to treat these situations with "symmetry" (*id.* at 11a), meaning that, if a taxpayer *paying* a liability in satisfaction of a disputed claim acquired in a business acquisition is required to capitalize rather than deduct its payment, a taxpayer *receiving* a payment in connection with such a claim should be able to treat that receipt as a capital gain. This need for symmetry arises because the theory underlying capital treatment is identical in both cases, which is that the payment and the receipt are each attributable to the capital transaction in which the disputed claim was acquired, and they have no relationship

to the ongoing "ordinary" business activities of the taxpayer. In fact, the appropriateness of this result is well illustrated in the instant case, where the taxpayer's corporations purchased the pending lawsuit against Xerox in the 1986 LBO and, in the same transaction, they assumed the seller's potential liability for Xerox's counterclaim in that lawsuit. It would be unfair and illogical to ignore the intervening LBO and to require the purchasers' successful resolution of that lawsuit to be taxed as ordinary income, as found by the court of appeals, unless it is also concluded that an *un*successful resolution of the same litigation, pursuant to which the purchasers had been required to pay off on Xerox's counterclaim, would similarly have been treated as "ordinary" (that is, deductible). Chief Judge Posner, in fact, recognizes and agrees with this need for symmetry, and his solution to the problem (discussed below) expressly applies to both scenarios. *Id.* at 8a-9a. In other words, Chief Judge Posner would treat the recovery from Xerox as ordinary income and, if the taxpayer had been required to pay off on the Xerox counterclaim, that payment would have been currently deductible.[6] Indeed, any conclusion that would treat

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[6] The majority opinion below does not expressly deal with the tax treatment that would have resulted if the taxpayer's corporations had been required to pay off on Xerox's counterclaim, but its conclusion that such a payment would have been deductible necessarily follows from (a) the theory underlying its analysis (that is, that the tax treatment of a claim is unaffected by an intervening corporate acquisition), (b) the court's explicit statement that *Pacific Transport* (involving precisely that question) was "incorrect" (App. 9a), and (c) the court's express statement that the taxpayer should be able to deduct the legal fees incurred in litigating the Xerox claim (App.

these "mirror image" transactions asymmetrically would be in direct conflict with the universally accepted doctrine that has long applied to the resolution of a disputed claim by the original parties thereto. That doctrine looks to the "origin of the claim" to determine the tax character of the settlement, and there are numerous cases applying this doctrine in equal measure to both the recipients of settlements or judgments and the payors thereof.[7]

Turning then to the rule adopted by the court of appeals, it was pointed out above that the court decided to search for a "simple" principle as to how the resolution of acquired claims should be taxed, with the stated goal of finding a rule that was "neutral," "in the sense of not

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8a-9a). Inasmuch as legal fees in pursuing or defending a lawsuit are deductible only where the origin of the lawsuit is "ordinary" rather than capital (*see Leonard v. Commissioner*, 94 F.3d 523, 526 (9th Cir. 1996)), it necessarily follows that Chief Judge Posner would have allowed the taxpayer's corporations to deduct any payments they would have made on the counterclaim as well.

[7] The symmetrical method of handling these matters can be seen by comparing two rather typical cases decided by the Seventh Circuit, each involving the original party to a lawsuit. In *Sager Glove Corp. v. Commissioner*, 311 F.2d 210 (7th Cir. 1962), the court held that the recovery of litigation proceeds were taxable as ordinary income to the recipient because, under the origin of the claim test, the litigation was "ordinary" in nature (it was a claim for lost profits). And, in *Clark Oil & Refining Corp. v. United States*, 473 F.2d 1217 (7th Cir. 1973), the court applied the same origin of the claim test to the payor of a judgment and held that, because the origin of the claim was capital (it arose out of the acquisition of a capital asset), the payment of the judgment was similarly capital. *See, e.g., Taxation of Damage Awards and Settlement Payments, supra* note 3, chs. 4, 6.

influencing business judgments." App. 7a. That goal, according to the court, was best met by treating the intervening acquisition as "merely an intermediate transaction" with no tax consequences, so that the "corporate acquisition [would] not affect the tax treatment of any claims that are transferred in the acquisition." *Id.* at 7a-8a. In other words, if the receipt of settlement or judgment proceeds would have been taxed as ordinary income to the original claimant, but if the claim is first sold to another party, any proceeds later received by the purchaser must similarly be taxed as ordinary income. *Id.* Similarly, if the payment of a settlement or judgment would have been deductible to the original party, such a payment is also deductible to a person who assumes the liability and subsequently is required to satisfy it. A contrary approach, according to the court, would "complicate and distort" the business judgment of a claimant by creating a tax advantage to assigning its claims rather than resolving them (*id.* at 7a), while the court's solution would have the beneficial result of avoiding any "incentive for corporate reorganizations." *Id.* at 6a. Using this approach, of course, the question presented in this case is easily answered because, if the Xerox litigation had been settled by Wehr prior to the 1986 LBO, the settlement payment would have been taxed to Wehr as ordinary income.[8] And, relying on this "simple" and "neutral" rule, the court had no difficulty in rejecting each of the taxpayer's arguments to the contrary. Therefore, in response to the Commissioner's argument that the taxpayer's settlement did not qualify for capital gains

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[8] *See* note 1 above.

treatment because a settlement does not constitute a "sale or exchange," as required for capital treatment under Internal Revenue Code § 1222,[9] the taxpayer's principal argument (citing such cases as *Arrowsmith v. Commissioner*, 344 U.S. 6) was that the required "sale or exchange" need not occur in the year of settlement, and that the statutory requirement was met by the 1986 LBO, *i.e.*, the transaction in which the claim was acquired by the taxpayer. The court of appeals rejected this argument as "just a conclusion," and stated, for the reasons discussed above, that the intervening LBO had to be ignored. App. 7a.

There are several problems with the court of appeals' approach, but the most serious is that, as Judge Cudahy acknowledges (App. 10a), it simply "ignores or excludes whole lines of authority" to the contrary.[10] Most directly, as both Chief Judge Posner and Judge Cudahy agree, the court's decision conflicts with *Pacific Transport Co. v. Commissioner*, 483 F.2d 209, a decision referred to by Judge Cudahy as on "all fours with the present case" (other than involving the "expense side" rather than the "income side"). App. 10a. In *Pacific Transport* the acquired corporation ("Old States") was a steamship company that lost a ship at sea. 483 F.2d at 211. A lawsuit was brought against Old States in connection with the loss of cargo (*id.*) and, if Old States had resolved the lawsuit with a payment in settlement or in satisfaction of a judgment,

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[9] This is the ground on which the Tax Court held for the Commissioner in this case. App. 32a.

[10] In fact, the majority opinion cites no authorities in support of its approach.

Old States could undoubtedly have been able to deduct the expenditure as a business expense. Instead, however, while the lawsuit was still pending, the business of Old States was sold to the taxpayer, which assumed the potential liability under the lawsuit.[11] *Id.* at 210-11. The lawsuit was later settled, and the taxpayer sought to deduct the settlement, but the Internal Revenue Service disallowed the deduction on the grounds that the settlement payment related back to the acquisition. *Id.* at 212. The Ninth Circuit agreed with the IRS, citing *Arrowsmith* among other authorities, and pointing out that

> "[t]he payment of a liability by a subsequent purchaser is not the discharge of a burden, which the law has placed upon him, but it is actually as well as theoretically, a payment of the purchase price."

Id. at 214. Therefore, the amount paid had to be capitalized as part of the basis of the acquired assets rather than deducted. This result is obviously contrary to the "simple" and "neutral" rule adopted by the court of appeals in the instant case, in that the intervening acquisition in *Pacific Transport*, rather than being irrelevant from a tax viewpoint, played the crucial role of turning what would have been an ordinary expense in the hands of the acquired corporation into a capital expense in the

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[11] The acquisition was accomplished through a purchase of Old States' stock for cash by New States, followed by an immediate liquidation of the acquired company into its new parent. Under the applicable tax law at the time (26 U.S.C. § 334(b)(2) (1954)), this was treated for tax purposes as if New States had purchased the assets (and assumed the liabilities) of Old States, meaning that the transaction is identical for tax purposes to the LBO in the instant case.

hands of the purchaser. And, as Judge Cudahy commented in the instant case, this result is "not surprising," because the intervening acquisition "changes the identity, circumstances and economic function of the taxpayer in ways that ought to be recognized in the analysis." App. 13a. Presumably because of the fundamental logic of the Ninth Circuit's conclusion, the principle enunciated in *Pacific Transport* has been universally recognized as representing the controlling law.[12] Nevertheless, the court of appeals opinion here simply dismisses *Pacific Transport* as "incorrect" (App. 9a) and, under the court's "simple" and "neutral" rule, the taxpayer in *Pacific Transport* would have been able to deduct the settlement because it would have been deductible if paid by Old States prior to the acquisition.[13]

Another crucial precedent is *Arrowsmith v. Commissioner*, 344 U.S. 6, which Chief Judge Posner attempts to distinguish (App. 8a), but which Judge Cudahy acknowledges (*id.* at 10a, 13a) is based on principles inconsistent with those adopted by the court here. In *Arrowsmith*, the

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[12] *See* Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶¶ 10.40[4], 10.42[6], and 10.43[2][d] (6th ed. 1997), and Martin D. Ginsberg and Jack S. Levin, *Mergers, Acquisitions, and Buyouts*, ¶ 3.04.2 (November 1999 ed.).

[13] This, of course, is the reason why the court's opinion will, unless and until corrected, lead to a significant revenue loss for the government, at least in the states comprising the Seventh Circuit. In his opinion, Judge Cudahy commented that, "[t]o no one's surprise," the government's counsel refused at oral argument to represent that the government would commit itself to "accept ordinary expense treatment when the shoe was on the other foot." App. 11a.

taxpayers were the sole shareholders of a liquidating corporation, and received its assets and liabilities in liquidation. 344 U.S. at 7. Subsequently, the taxpayers were required, as corporate transferees, to satisfy a judgment against the corporation arising out of its pre-liquidation activities. *Id.* There was no doubt but that, if the liquidated corporation had still been in existence and if *it* had paid the judgment prior to its liquidation, the payment of the judgment would have been deductible as a business expense.[14] Nevertheless, the Internal Revenue Service objected when the taxpayers deducted their payment, and this Court sided with the Service. *Id.* at 7-8. Citing the predecessor to today's Internal Revenue Code Section 1221, treating losses from the "sale or exchange" of "capital assets" as capital losses, and citing also the Code provisions treating corporate liquidations as "exchanges" of the shareholders' stock for this purpose, this Court held that the payments made by the taxpayers in satisfaction of the judgment fell "squarely" within the definition of a "capital loss." *Id.* at 8. Crucial to the Court was its conclusion that "it is plain that [the shareholders'] liability as transferees was not based on any ordinary business transaction of theirs apart from the liquidation proceedings." *Id.* It can be seen that the court of appeals'

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[14] The details of the underlying lawsuit are not set forth in the Supreme Court's opinion in *Arrowsmith*, but the nature of that lawsuit is made clear in the *Arrowsmith* court of appeals' decision (193 F.2d 734 (2d Cir. 1952)) and in the underlying state court litigation (*Trounstine v. Bauer, Pogue & Co.*, 144 F.2d 379 (2d Cir. 1944)). It is clear from those decisions that the dispute arose out of the ordinary business activities of the liquidated corporation.

decision in the instant case cannot be reconciled with *Arrowsmith* since, contrary to the rule adopted here, the tax treatment of the payment of a business claim was changed in that case from ordinary to capital by an intervening capital transaction. This inconsistency was recognized by Judge Cudahy, who refers to *Arrowsmith* as being "to the same effect" as *Pacific Transport* (App. 10a) and who acknowledges that the principle adopted by the court here "did not control" in either *Arrowsmith* or *Pacific Transport* (*id.* at 13a). As pointed out previously, however, Chief Judge Posner attempts to distinguish *Arrowsmith* on the ground that all that case stands for is the "unexceptionable proposition" that, because the *Arrowsmith* taxpayers recognized a capital gain on the earlier liquidation, it would have resulted in an unfair "tax windfall" if they were later allowed to deduct their subsequent payment. *Id.* at 8a. Consequently, Chief Judge Posner would limit *Arrowsmith* to situations in which the earlier transaction generated a taxable gain or loss to the taxpayer, and he would restrict that case to a holding that the later transaction must be taxed in a manner consistent with the earlier one. In fact, however, *Arrowsmith* has been interpreted more broadly, as illustrated by the Ninth Circuit's citation of *Arrowsmith* as one of the authorities supporting its holding in *Pacific Transport*. In *Pacific Transport*, as in the instant case, the earlier transaction was an acquisition with no immediate tax consequences to the taxpayer, and the consistency required by the Ninth Circuit was between the capital nature of the transaction in which the claim was purchased by the taxpayer and the loss that occurred when that claim was resolved. Moreover, the stated rationale in *Arrowsmith* was that the claim

in question did not arise out of the taxpayer's "ordinary business transactions"; this is also true in *Pacific Transport* and in the instant case, and the *Arrowsmith* doctrine should therefore apply regardless of whether the earlier transaction resulted in a taxable gain or loss to the taxpayer.

III. THE COURT OF APPEALS' DECISION FAILS TO MEET ITS OWN GOALS OF "SIMPLICITY" AND "NEUTRALITY."

The decision of the court of appeals is ostensibly based on its quest for a "simple" and "neutral" tax rule that will not affect business decisions. The rule adopted by the court, however, does not meet those goals.

First, if Wehr had retained the pending Xerox claim, if it had then distributed the claim with its other remaining assets to its shareholders in liquidation, and if those shareholders had later received a recovery from Xerox, that recovery would have been treated as part of the liquidation transaction and taxed to the shareholders as a long-term capital gain. This result follows from a 1969 decision of the United States Tax Court, in which the Internal Revenue Service has formally acquiesced. *Shea Co. v. Commissioner*, 43 T.C. 135 (1969), *acq.*, 1970-2 C.B. xxi.[15] That being true, however, the court of appeals' decision here will create a significant tax distinction between selling a pending claim as part of a sale of corporate assets, or retaining the claim and distributing it

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[15] This is now recognized as the accepted rule on this issue. Bittker & Eustice, *supra* note 12, ¶ 10.03[2].

in corporate liquidation, creating precisely the tax "complications" and "distortions" that the court of appeals stated it was trying to avoid. App. 7a.[16]

Similarly, the majority opinion below creates a significant distinction between selling a pending claim and settling it, inasmuch as Chief Judge Posner assumes that, if the taxpayer had sold the claim rather than settling it, he would then have been entitled to capital gains treatment on his sales proceeds. App. 4a. It is unclear, however, how this conclusion can be reconciled with the court's goal of "neutrality" since, if Wehr (as the original claimant) had sold the claim and received money therefor, the proceeds would have been taxed to it as ordinary income under such precedents as *Hort v. Commissioner*, 313 U.S. 28 (1941), holding that a payment received as a replacement for anticipated future ordinary income is itself taxed as ordinary income. Moreover, as Judge Cudahy points out (App. 12a), it is hard to see the "neutrality" of a rule that would have allowed the taxpayer here to avoid ordinary income treatment by the simple expedient of selling the Xerox claim to another party rather than settling it. Indeed, one commentator has

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[16] It is also impossible to determine any principled reason for treating the settlement of the claim as a capital gain if received by the shareholders of the corporation in whose business the claim arose, while treating that settlement as ordinary income if received by a purchaser of the corporation's assets. In neither event does the claim arise out of the business activities of the taxpayer and, in both situations, it has been acquired in a capital transaction from the original claimant.

already suggested that this is the manner in which the result of this case can easily be avoided.[17]

Finally, it is difficult to understand the potential planning abuses at which the court of appeals' decision is directed, since there are few if any situations in which a party to a claim for its own lost business profits could obtain a tax benefit from a contrary rule. For example, as pointed out above, if the original claimant sells its claim, any payment received therefor will be taxed as ordinary income.[18] Apparently, Chief Judge Posner recognized this, because he speculated that, if an assignment of the claim were permitted to change the tax classification of the claim proceeds, the "effect . . . would be to give an owner of legal claims an incentive to spin them off into a new corporation and sell the corporation, rather than selling the claims directly." App. 6a. Although the precise transaction described here is not entirely clear, it appears that the Chief Judge is relying on the assumption that this would be tax-free to the original claimant, but that assumption is erroneous. If the claim and other business assets were to be transferred to the new corporation in return for its stock, that contribution would be tax-free to the claimant only if it qualifies under I.R.C. § 351, and that Section requires that the contributor remain in control of the new corporation for some period after the contribution.[19] Therefore, if the stock of the new corporation were quickly sold, as hypothesized by Chief Judge

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[17] Burgess J. W. Raby and William L. Raby, *The Double-Edged Blade of 'Sale or Exchange'*, 81 Tax Notes 749 (1998).

[18] *See Hort v. Commissioner*, 313 U.S. 28.

[19] Bittker & Eustice, *supra* note 12, ¶ 3.09.

Posner, the original contribution would become a taxable transaction and, in that event, the fair market value of the stock received by the claimant would be taxable in the same manner as cash, resulting in ordinary income to the claimant under the principles of *Hort v. Commissioner*. Moreover, if *only* the claim were contributed to the new corporation, I.R.C. § 351 would likely not apply in any event, meaning once more that the claimant would have immediate ordinary income.[20] In summary, if there is an opportunity for aggressive tax planning in connection with these types of transactions, that opportunity has been opened by the court of appeals' decision, and has by no means been closed thereby.[21]

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[20] Bittker & Eustice, *supra* note 12, ¶ 3.17.

[21] One other puzzling argument made by the court below in favor of its conclusion is that a contrary decision would conflict with the treatment of interest received by the purchaser of a corporate bond. According to Chief Judge Posner, the taxpayer in this case was in the same position as if he had purchased a corporate bond from Wehr Corporation as part of the 1986 LBO, and subsequently earned interest thereon, since "[i]n both cases, what was transferred as part of a corporate acquisition was an asset that yields ordinary income, an asset that the purchaser as it were 'milks' for that income rather than selling the asset." App. 5a. The flaw in this argument was recognized by Judge Cudahy (App. 13a-14a), who pointed out correctly that, in the bond example, the interest in question would be directly attributable to, and earned during, the post-LBO period, while neither the Xerox claim nor the ensuing litigation had anything whatsoever to do with the taxpayer's post-1986 business operations.

IV. THE DECISION OF THE COURT OF APPEALS ALSO RAISES SIGNIFICANT QUESTIONS AS TO A NUMBER OF OTHER LONG-ACCEPTED TAX DOCTRINES.

The taxpayer raised a number of other significant questions below, which received little discussion by the court of appeals because of its determination to establish its own new "simple" and "neutral" rule. These questions are, nevertheless, of substantial importance to the administration of the federal tax laws, and this Court might wish to take this opportunity to clarify how several long-accepted tax doctrines are to be applied to the not uncommon fact pattern herein presented.

First, there is the doctrine of "origin of the claim," under which the resolution of a disputed claim for monetary damages (whether by settlement or judgment) is taxed to both parties in accordance with the nature of the underlying claim. *United States v. Gilmore*, 372 U.S. 39. This doctrine has been construed as meaning that, if the origin of the claim was the acquisition or disposition of a capital asset, its resolution is similarly treated as capital in nature.[22] In the instant case, the taxpayer contended below that the "origin of the claim" has to be determined by reference to the origin of the claim *to the taxpayer's corporations* and not to Wehr (an unrelated party), and that the relevant origin here was the 1986 LBO, a capital transaction, and not the ordinary business operations of

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[22] *See, e.g., Woodward v. Commissioner*, 397 U.S. 572 (1970) and *Anchor Coupling Co. v. Commissioner*, 427 F.2d 429 (7th Cir. 1970).

the purchasing corporations. The court of appeals, however, rejected this argument on the grounds that the origin was to be determined by reference to the original claimant, ignoring the intermediate LBO. App. 4a. And, inasmuch as the Xerox claim in this case arose out of Wehr's ordinary business activities, it followed (according to the court of appeals) that the resolution of that claim was to be treated as non-capital both to Wehr and to the taxpayer. Guidance is needed from this Court, then, as to whether the "origin of the claim" test is to be applied by reference to origin of the claim *to the taxpayer*, or to the origin *to the original claimant*.

Second, one of the arguments that the Commissioner has been making in this case is that the settlement of the Xerox claim cannot be treated as capital in nature because there was no "sale or exchange" of that claim in 1992, the year of settlement, as required by I.R.C. § 1222. The taxpayer's principal response to this argument has been that the "sale or exchange" requirement can be met by the transaction in which the claim was acquired (as in *Arrowsmith* and *Pacific Transport*), but the court of appeals, holding that the 1986 LBO was to be ignored for tax purposes, concluded to the contrary. In addition, the taxpayer argued that, although it was generally true that the settlement of a lawsuit by itself does not normally rise to the level of a "sale or exchange," there are precedents holding to the contrary under appropriate facts and circumstances. *See Commissioner v. Ferrer*, 304 F.2d 125, 131 (2d Cir. 1962) (in which Judge Friendly rejected this sale versus settlement distinction as "formalistic" and "nonsensible") and *Turzillo v. Commissioner*, 346 F.2d 884, 890 (6th Cir. 1965) (also rejecting this distinction as having

"little merit"). The Commissioner has cited numerous cases to the contrary,[23] and guidance from this Court on the "sale or exchange" concept in the context of litigation settlements would be extremely helpful.

Third, the taxpayer in this case has argued that, under the so-called "open transaction" doctrine adopted by this Court in such cases as *Burnet v. Logan*, 283 U.S. 404, the fact that the Xerox claim was too speculative to value at the time of the 1986 LBO meant that the later resolution of that claim should be treated as an integral component of the 1986 transaction, again leading to the conclusion that that resolution was capital in nature. In direct support of this argument, the taxpayer cited such cases as *Shea Co. v. Commissioner*, 53 T.C. 135, and the Commissioner's acquiescence therein. The court of appeals rejected this argument, holding that the "open transaction" doctrine applies only to sellers of capital assets. App. 9a-10a. In the *Shea Co.* case, however, the taxpayers were corporate shareholders who received a pending claim of indeterminate value in a corporate liquidation and, under the "open transaction" doctrine, the later receipt of a payment in satisfaction of that claim was treated for tax purposes as an additional asset received by them in the liquidation. The transaction under discussion here is similar, in that the taxpayer's corporations acquired a pending claim of indeterminate value in a corporate acquisition, and the $6 million they ultimately received in satisfaction of that claim should be treated as

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[23] The conflicting cases on both sides of this issue are discussed in *Litigation Settlements: Are They Ordinary Income Or Capital Gain?*, *supra* note 3.

just another asset received by them in the earlier acquisition. Ideally, as Judge Cudahy points out, this treatment might well be completely non-taxable, and merely result in a $6 million reduction in the initial tax basis of the other assets purchased by the taxpayer (because it would effectively reduce the purchase price paid therefor) but, for reasons explained in the record, that was impossible.[24] The alternative, then, is to treat those proceeds as long-term capital gain, and the court of appeals' refusal to extend the "open transaction" doctrine to this type of transaction needs review by this Court.

CONCLUSION

For the reasons stated herein, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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[24] In a separate tax dispute resolved before the present dispute began, the taxpayer and the Commissioner entered into a Closing Agreement, pursuant to which the initial basis of the assets purchased in the 1986 LBO was established for all tax purposes.

In the

United States Court of Appeals

for the Seventh Circuit

No. 99-1149

BRIAN L. NAHEY and CAROL J. NAHEY,

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Appeal from the United States Tax Court.

ARGUED SEPTEMBER 13, 1999 – DECIDED NOVEMBER 17, 1999

Before POSNER, *Chief Judge*, and CUDAHY and KANNE, *Circuit Judges*.

POSNER, *Chief Judge*. This appeal from a decision by the Tax Court against the taxpayers, Brian Nahey and his wife, presents a question that one might (wrongly) have supposed resolved long ere now: if a legal claim for lost corporate income is sold as part of the sale of the corporation, and is later settled, are the proceeds of the settlement ordinary income or capital gain? The Tax Court held they were ordinary income. 111 T.C. 256 (1998).

Wehr Corporation, a manufacturer of industrial equipment, sued Xerox Corporation for damages arising from Xerox's alleged breach of a contract with Wehr to sell it a computer system that would satisfy all of Wehr's data-processing needs. The suit charged fraud as well as simple breach of contract and sought lost profits. Damages in excess of $5 million (including punitive damages) were claimed. Xerox counterclaimed for the unpaid portion of the contract price, some $650,000. While the suit was pending, the majority shareholder in Wehr offered to sell the company to Brian Nahey, its president, for $100 million. The sale took the form of a leveraged buyout (meaning that the assets of the company were pledged to secure a loan that provided the purchaser with the funds necessary to pay the purchase price) by two subchapter S corporations formed and owned by Nahey. (His wife is a party to this litigation only because the couple filed a joint return.) For tax purposes, a subchapter S corporation is identical to its shareholders, so we'll refer to Nahey's two S corporations simply as "Nahey." In allocating the $100 million purchase price of Wehr across Wehr's specific assets, an accounting firm hired by Nahey assigned no value to the suit against Xerox, regarding it as too speculative to be valued.

The sale of Wehr to Nahey took place in 1986. Six years later, the suit (now Nahey's) against Xerox was settled. Xerox agreed to pay Nahey $6 million and to dismiss its counterclaim. Nahey concedes that if Wehr hadn't been sold, and if it had settled its suit against Xerox on the same terms that Nahey did, the entire settlement price of $6 million would have been taxed to Wehr as ordinary income rather than as a capital gain

because the amount received in the settlement would have replaced ordinary income of which Xerox had deprived Wehr. *Alexander v. Commissioner*, 72 F.3d 938, 942-44 (1st Cir. 1995). (The rule is arbitrarily different in the case of suits for personal injuries; only punitive damages are taxable in such cases even if the judgment or settlement is mainly for lost earnings that would have been ordinary income if not lost because of disability caused by the defendant's wrongdoing. 26 U.S.C. § 104(a); see *O'Gilvie v. United States*, 519 U.S. 79, 86 (1996); 1 Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates, and Gifts* ¶ 13.1.4 (3d ed. 1999).) If the settlement proceeds had replaced a capital gain, they would have been taxed as a capital gain. *Anchor Coupling Co. v. United States*, 427 F.2d 429, 433-34 (7th Cir. 1970). That is all that *Anchor Coupling*, on which Nahey relies, held, and it doesn't help him since the origin of his claim was a claim to ordinary income, not to a capital gain.

It is true that when a taxpayer sells a capital asset, the income he receives from the sale is a capital gain. 26 U.S.C. §§ 1221, 1222. And we may assume that the suit against Xerox was a capital asset of Wehr and was acquired together with Wehr's other assets in the purchase of the corporation by Nahey. A capital asset is "property held by the taxpayer," 26 U.S.C. § 1221; *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212, 217-18 (1988), and while there are exceptions in section 1221 none of them embraces legal claims, although there is some authority for refusing to classify a right to ordinary income as a capital asset, see *id.* at 217 n. 5, and Wehr's claim against Xerox could be so characterized. That is

why we are merely assuming that a sale of the claim would have produced a capital gain, rather than ordinary income, to Wehr. For the sake of completeness we add that, on this assumption, the fact that the accountants declined to value this asset because it was speculative would not undermine its character as a capital asset; it would merely give it a zero basis.

But even if the sale of the suit would have produced capital gain (or loss) to the seller, the purchaser, when he prosecuted the suit to judgment and collected the judgment, or when he settled the case and received the proceeds of the settlement, would be taxable on the net gain at the ordinary-income rate. *Ogilvie v. Commissioner*, 216 F.2d 748 (6th Cir. 1954) (per curiam). This is critical because Nahey did not sell the suit; he prosecuted it to settlement himself. The settlement proceeds were therefore ordinary income to him. A settlement, or equally a litigated judgment, resembles a sale because it extinguishes the plaintiff's claim. But our hypothetical example shows the difference between assigning and enforcing a legal claim. If a settlement or judgment were the sale of an asset, then had Wehr not been sold to Nahey, but had instead obtained the settlement with Xerox itself, the proceeds would (we're assuming) be a capital gain to Wehr – yet Nahey concedes that they would be ordinary income to Wehr. The concession is compelled by the principle that "the [tax] classification of amounts received in settlement of litigation is to be determined by the nature and basis of the action settled, and amounts received in compromise of a claim must be considered as having the same nature as the right compromised." *Alexander v. Commissioner, supra*, 72 F.3d at 942.

To nail this point down, let's suppose Wehr had owned a $1,000 face-amount coupon bond due in 1992 and paying 5 percent annual interest, and the accountants had valued it at $1,000 in the sale of Wehr's assets to Nahey. Between 1986 and 1992, Nahey would have clipped the coupons and received interest of $50 per year ($500 in total) taxable as ordinary income. Then in 1992 he would have cashed in the bond for its face amount, a nontaxable return of principal. Compare that to a variant of this case in which the accountants value the suit against Xerox at $1 million. Then $1 million of the $6 million would have been the cost of the asset to Nahey and would be deducted from the proceeds of the settlement in computing Nahey's income from the settlement. The balance of $5 million would be ordinary income, just like the interest on the bond. It shouldn't make a difference that Wisconsin law (the governing law in the Xerox case) cut off Nahey's right to recover for Wehr's lost profits as of the date of the sale of the corporation to him, while in the case of the bond the interest is received after the acquisition. The proceeds of the settlement were received after the settlement, just as the interest on the bond was received after the bond was purchased. The proceeds of the settlement represented overdue ordinary income, but that didn't make it a capital gain. In both cases, what was transferred as part of a corporate acquisition was an asset that yields ordinary income, an asset that the purchaser as it were "milks" for that income rather than selling the asset.

Lest the foregoing analysis seem too formalistic for some tastes, we add that we cannot find any practical reason for why the tax treatment of the proceeds of a suit

should change merely because of an intervening change in ownership. Recall the taxpayers' concession that if Wehr had obtained the settlement the proceeds would have been taxable to Wehr as ordinary income, not as a capital gain. Recall too that if Wehr had assigned the suit to someone else, that someone else would have had to pay tax on the net proceeds from any settlement or judgment (net, that is, of the price of the assignment) at ordinary-income rather than capital-gains rates. Why should it make a difference that the assignment was packaged with a sale of other assets (the rest of Wehr's assets) as well? *Canal-Randolph Corp. v. United States*, 568 F.2d 28, 30, 33 (7th Cir. 1977) (per curiam), assumes that it makes no difference, consistent with the principle that a merger or other corporate acquisition does not alter the tax status of the assets involved in it. E.g., *United States v. Hilton Hotels Corp.*, 397 U.S. 580 (1970).

The only effect of permitting the assignment to change the tax classification of the eventual proceeds would be to give an owner of legal claims an incentive to spin them off into a new corporation and sell the corporation, rather than selling the claims directly. The attempt to obtain favorable tax treatment for the purchaser (and hence a higher purchase price) by this route might be thwarted by the "substance over form" doctrine, see, e.g., *Yosha v. Commissioner*, 861 F.2d 494, 497-98 (7th Cir. 1988), but why invite that complication? Why create an added incentive for corporate reorganizations (have we a shortage of them?), which would be the consequence of the rule for which the taxpayers contend in any case in which a corporation has substantial assets in the form of legal

claims the enforcement of which would yield ordinary income to the corporation.

Sometimes when a company is sold, the seller retains some or all of its legal claims (more commonly, its legal liabilities, as in *Chaveriat v. Williams Pipe Line Co.*, 11 F.3d 1420, 1424 (7th Cir. 1993)), for example by spinning off the claims into a newly formed corporation, because the purchaser may not be able to form a good idea of their merits or may fear the contingent liabilities that the prosecution of a claim often entails – remember Xerox's counterclaim, which depending on the court's rulings might have ended up being worth more than Wehr's claim. Why complicate and distort the business judgment of the parties as to whether to retain or assign legal claims by creating a tax incentive to assign them?

In an effort to bring himself within *Anchor Coupling*, Nahey argues that the claim which was settled was capital in origin, the origin being the LBO. But that is just a conclusion. It is more sensible, for the reasons just explained, as well as fully compliant with the legal formalities, to regard the LBO as merely an intermediate transaction between the original claim, which was to recover ordinary income of which Wehr had been wrongfully deprived, and the settlement of that claim after its transfer to Nahey.

It is desirable that rules of taxation be simple and that they be neutral, in the sense of not influencing business judgments except when the purpose of a particular provision of tax law is to influence behavior, which is not contended to be the case here. Judged by this twofold standard the Tax Court's decision is sound; a corporate

acquisition should not affect the tax treatment of any claims that are transferred in the acquisition. Against this the taxpayers point to cases in which the government successfully argued that a deduction taken with respect to an asset acquired as part of a corporate acquisition was a capital loss. The leading case is *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), but as explained in *United States v. Skelly Oil Co.*, 394 U.S. 678, 685 (1969), all it stands for is the unexceptionable proposition that "if money was taxed at a special lower rate when received, the taxpayer would be accorded an unfair tax windfall if repayments [of that money] were generally deductible from receipts taxable at the higher rate applicable to ordinary income." See also 2 Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts* § 52.1.9, p. 52-19 (2d ed. 1990). That proposition underlies the Tax Court's decision in this case, which merely requires that the tax classification of a legal claim remain unaltered through transfer of the claim whether by assignment or as an incident to a corporate acquisition or other reorganization.

Suppose that Nahey had sold the suit against Xerox rather than prosecuting it and had incurred an expense of $10,000 in negotiating the sale, and that the gain on the sale was taxable at capital-gain rates. He would not be permitted to deduct that expense from ordinary income; he would have to deduct it from the sale price and thus reduce his capital gain rather than his ordinary income. *Woodward v. Commissioner*, 397 U.S. 572, 578 (1970). In some of the cases that Nahey cites, the court may have misclassified an expenditure (he points chiefly to *Pacific Transport Co. v. Commissioner*, 483 F.2d 209 (9th Cir. 1973)

(per curiam)), and treated an ordinary expense as a capital one. If so (which we needn't decide), those cases are incorrect; but there is no principle that an incorrect decision creates a right in a taxpayer to whom that decision has never been applied. Should the government ever claim that the legal expenses incurred by Nahey in obtaining the settlement were capital rather than ordinary – a contention the government's lawyer disclaimed at argument – the Tax Court will be required to reject the contention.

Nahey tries to fit the case into the "open transactions" doctrine, which in its simplest version allows a person who sells property in exchange for a stream of payments contingent on the profits generated by the property to treat the stream as a capital gain, though it looks like ordinary income. The doctrine is designed for cases in which neither the property nor the contingent mode of payment for it can be valued at the time of the sale, so that the taxpayer cannot be accused of having attempted to transform ordinary income into a capital gain; he took the capital gain in the only form that was feasible. 2 Bittker & Lokken, *supra*, § 52.1.9, p. 52-18. The doctrine presupposes that if the property could have been sold for a definite sum, that sum would have been taxable as a capital gain, not ordinary income. Had Wehr sold its claim against Xerox (whether directly or through a corporate reorganization) to Nahey in exchange for a "cut" of any judgment or settlement proceeds, and if – the question we left open earlier – the sale of a legal claim to ordinary income can ever yield a capital gain rather than ordinary income to the seller, then conceivably Wehr could have treated that "cut" when received as a capital

gain. But the issue is *Nahey's* tax liability, and to that the open transactions doctrine is irrelevant.

AFFIRMED.

CUDAHY, *Circuit Judge*, concurring. I write separately because, although there is much to support the majority opinion, there is considerable to throw it in doubt. And I am troubled that it ignores or excludes whole lines of authority. For example, the majority flatly rejects such cases as *Pacific Transport Co. v. Commissioner*, 483 F.2d 209 (9th Cir. 1973), where the government successfully argued that a payment made by a parent corporation in discharge of a contested tort liability was not an ordinary loss and thus currently deductible. The tort claim in question was first asserted against a subsidiary corporation and necessarily assumed by the parent corporation upon liquidation. The Ninth Circuit held that the loss should have been capitalized and added to the parent's basis in the assets acquired from the subsidiary. *Pacific Transport* is on all fours with the present case except that it involves the expense side rather than the income side. *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), involving payment of a judgment after a corporate liquidation, is to the same effect and the majority's effort to distinguish it merely points to the unusual inequity of a contrary outcome. Nonetheless, the principles underlying *Arrowsmith* are the same as those argued by the taxpayer here. For, in *Arrowsmith*, what the majority calls an "intermediate transaction" determined the tax treatment of the payment of a judgment.

At oral argument, the panel asked questions of government counsel reflecting its concern that the government, after successfully arguing for capital treatment in cases like *Pacific Transport* involving the characterization of expenses, would continue to fight for ordinary income treatment when the issue involved the characterization of *income*. To no one's surprise, government counsel refused to represent that in the future the government would accept ordinary expense treatment when the shoe was on the other foot. In fact, government counsel's bottom line was "I don't think it's clear how the IRS would treat it if [Nahey] had paid out money. . . . I can't speak for the IRS." But this Court has, in related contexts in the past, aspired to treat settlement expenses and settlement income symmetrically. *See e.g. Canal-Randolph v. United States*, 568 F.2d 28, 33 (7th Cir. 1977). In fact, in *Canal-Randolph* government counsel assured us that in that case at least the IRS would aim for symmetry even at a cost in revenue. But perhaps at this point the cause of symmetry has waned.

It may therefore be a little unrealistic and a little unfair to deny taxpayers the benefit of cases holding, in circumstances analogous to the present case, that expenses must be capitalized. It is *unrealistic* because we seem to entertain the hope that our result is so "simple" and so "neutral" that other courts will follow it (presumably in preference to their own precedents) equally in income and in expense cases. In the same vein, we hope that the government will be so persuaded by our analysis that it will cease taking a position in all kinds of cases that merely maximizes the revenue – whatever its logical inconsistencies. I think it is unrealistic – even naive – for

us to have such expectations. It is *unfair* because we deny taxpayers the benefit of precedents that support in principle the capitalization of income, even though they deal immediately with issues of loss and expense.

Another consideration much esteemed by the government but a dubious contributor to simplicity and neutrality is the presence or absence of a sale or exchange. For the difference between a sale or exchange of a capital asset and its disposition by other means, such as by settlement, has never been simple or neutral. The congressional *purpose* in the distinction between capital gain and ordinary income seems to have been to distinguish "between recurring receipts such as salaries, wages, interest, rents, dividends, royalties, and the like on one hand, and the nonrecurrent realization of *the appreciation in the value of property* on the other." Stanley S. Surrey, *Definitional Problems in Capital Gains Taxation*, 69 Harv. L. Rev. 985, 1003-4 (1956) (emphasis supplied). Courts have seized on "sale or exchange" language to limit the conversion of ordinary income into capital gains. The other side of the coin is that the "presence of a 'sale or exchange' requirement produces incongruous results when an admitted capital asset is disposed of by means other than sale or exchange. . . . " *Id.* at 1007. It is hard to see how taxing Nahey's gain as ordinary income is a simple or neutral rule when, if he had sold the claim for the settlement amount, he would have realized capital gain.

The majority says that the settlement of the lawsuit here yields ordinary income because the amount received in settlement replaced ordinary income of which Xerox had deprived Wehr. But the government seems to prefer

the rationale that a settlement cannot generate a capital gain because a settlement is not a sale or exchange. However, if we could get beyond this linguistic hurdle, in the hands of Nahey the settlement could arguably represent a reduction in Nahey's cost basis in the other assets acquired from Wehr (a mirror image of *Pacific Transport*), not a replacement of ordinary income.

The majority has also adopted the principle that a corporate sale is "merely an intermediate transaction between the original claim, which was to recover ordinary income of which [the original taxpayer] had been wrongfully deprived, and the settlement of that claim after its transfer to [a new taxpayer]." This principle has a ring of clarity and simplicity about it, but it did not control in either *Arrowsmith* or *Pacific Transport* or in like cases, where an "intermediate transaction" is the key to the result. Perhaps this is not surprising because an "intermediate transaction" generally changes the identity, circumstances and economic function of the taxpayer in ways that ought to be recognized in the analysis. For example, if a car appreciates in the hands of a car dealer, the gain is generally ordinary. 26 U.S.C. § 1221(1). If it appreciates in the hands of a customer to whom the car has been sold, the gain is generally capital.

The problematic effort of the majority to make this puzzle appear simple is best illustrated by its bond analogy. Of course, coupon interest on a high-quality bond, periodically paid at prescribed intervals, is ordinary income, no matter how many corporate transfers have preceded the clipping of the coupons. But, unlike the claim in the present case, bond interest is earned almost

contemporaneously with its receipt. In fact, in the example given in the majority opinion it is *earned* in the hands of the successor corporation. This is not unlike the yardage earned by the purchaser after the transfer in *Canal-Randolph*. This is unlike the claim in the instant case where whatever is earned in the settlement reflects legal relations established before the transfer. In the case of bond interest, there is no reason to look at events before the transfer, since the interest is a wholly post-transfer phenomenon.

A junk bond might furnish a more helpful analogy. This is a bond that could be valued at the time of corporate transfer far below par because of the risk of nonpayment of interest or of non-recovery of capital. When the bond later is redeemed at face value in the hands of the transferee the part of the gain attributable to the time value of money would be treated as ordinary income and the balance as capital gain. The increase in value of a junk bond when redeemed, reflecting a reward for the transferee's successful risk-taking, might be analogized to the settlement of the "speculative" lawsuit in the instant case.

Given all these important considerations, I think we must give proper weight to authoritative decisions like *Pacific Transport*, which require taxpayers to capitalize losses and which argue for symmetrical treatment on the income side. To ignore this authority adds to the mistaken impression that this is an easy case. It is far from an easy case, and efforts to make it into one may do more harm than good. My observations about various aspects of the majority opinion indicate why a strong tilt toward the tax collector is unwarranted. The arguments and authorities on both sides are so close to equipoise that a

decision is difficult. To resolve the matter, I think that some deference is due the Tax Court, which deals regularly with the issues that trouble us. I, therefore, despite substantial doubt, elect to adopt the same outcome as the majority, even though I seriously question important aspects of its analysis.

A true Copy:

Teste:

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Clerk of the United States Court of Appeals for the Seventh Circuit

UNITED STATES TAX COURT
WASHINGTON, D.C. 20217

BRIAN L. and CAROLE J. NAHEY	*	
Petitioners,	*	Docket No.
V.	*	8497-96
COMMISSIONER OF INTERNAL REVENUE	*	
Respondent.	*	

DECISION

Pursuant to the Opinion of the Court, 111 T.C. No. 13, filed October 21, 1998, it is

ORDERED and DECIDED that there is a deficiency in income tax due from petitioners for the taxable year 1992 in the amount of $185,833.00.

(Signed) Julian I. Jacobs
Julian I. Jacobs
Judge

ENTERED: OCT 22 1998

111 T.C. No. 13

UNITED STATES TAX COURT

BRIAN L. AND CAROLE J. NAHEY, Petitioners
v. COMMISSIONER OF
INTERNAL REVENUE, Respondent

Docket No. 8497-96. Filed October 21, 1998.

W, a corporation, sued X for breach of contract and misrepresentation for failing to complete the installation of a computer system and sought damages for lost profits. X counterclaimed for withheld payments by W.

In 1986, P, through his two S corporations, acquired all of the assets and assumed all of the liabilities of W, including W's lawsuit against X and X's counterclaim against W. W was thereafter liquidated. No part of the purchase price for W's assets was allocated to the claim against X.

In 1992, the lawsuit with X was settled for total consideration of $6,345,183. The settlement proceeds were paid to the S corporations and reported as long-term capital gain that passed through to P. R determined that the settlement proceeds constituted ordinary income. P asserts that the lawsuit constituted a capital asset and that the settlement of the lawsuit constituted a sale or exchange for purposes of the capital gain provisions. *Held*: The settlement of the lawsuit between the S corporations and X did not constitute a sale or exchange pursuant to sec. 1222, I.R.C., and thus the settlement proceeds received by the S corporations and passed through to P constitute ordinary income.

Robert A. Schnur and *Joseph A. Pickart*, for petitioners.

George W. Bezold and *Christa A. Gruber*, for respondent.

JACOBS, *Judge*: Respondent determined a $185,833 deficiency in petitioners' 1992 Federal income taxes.

The deficiency herein arises from the parties' dispute over the characterization of settlement proceeds from a lawsuit that was brought by a corporation whose assets, including the lawsuit, were purchased by petitioners' two S corporations. The sole issue we must decide is whether the settlement proceeds received by the S corporations (and passed through to petitioners) constitute ordinary income, as respondent contends, or long-term capital gain, as petitioners contend.[1]

All section references are to the Internal Revenue Code as in effect for the year in issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulated facts are incorporated in our findings by this reference.

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[1] In their petition contesting respondent's determination that the settlement proceeds received by the S corporations (and passed through to petitioners) constitute ordinary income, petitioners asserted, as an alternative position, that the S corporations should have reported the settlement proceeds as a nontaxable return of capital. In their posttrial brief, petitioners abandoned this alternative argument.

At the time the petition was filed, petitioners Brian L. and Carole J. Nahey, husband and wife, resided in Hartland, Wisconsin. (All references to petitioner in the singular are to Mr. Nahey.)

Wehr Corporation

Wehr Corporation (Wehr), a Wisconsin corporation, manufactured and distributed a variety of industrial equipment and devices, such as air distribution equipment, high-technology electronics, motor brakes, clutches, and refractory brick presses.

From the mid-1970's until the end of 1986, petitioner held the positions of president, chief executive officer, and member of the board of directors of Wehr.

At the end of 1986, petitioner owned approximately 10 percent of the stock of Wehr, Bruce A. Beda (who is not described in the record) owned an additional 3 percent, and the balance of the stock was owned by members of the Manegold family directly or through trusts established for their benefit.

The Xerox Lawsuit

On December 31, 1983, Wehr contracted with Xerox Corporation (Xerox) to implement and install a fully integrated on-line, closed loop computer system to unite all of Wehr's operational, managerial, and administrative functions in a real-time manner. Upon installation, this system would have given Wehr a competitive edge in its marketplace, increasing its revenues and profits.

Pursuant to the terms of the contract, which were negotiated by petitioner on behalf of Wehr, Xerox agreed to complete the project by December 31, 1984. During the period in which Xerox was to implement and install the new system, Xerox allowed Wehr to run its (Wehr's) information services systems on Xerox's computers in California on a fee-for-service basis of approximately $70,000 per month.

From the inception of the project, Xerox fell behind schedule and missed target dates. Wehr responded to Xerox's missed target dates by withholding payment of the monthly fee for using Xerox's computer services in California. In January 1985, at which time Wehr estimated that only 1 to 2 percent of the required services had been performed, Xerox warned Wehr that its continued failure to pay would result in the termination of all services. Nonetheless, Wehr still refused to pay, and Xerox terminated all services. At that time, Wehr allegedly owed $652,984.33 to Xerox.

On February 11, 1985, Wehr filed a lawsuit against Xerox in the United States District Court for the Eastern District of Wisconsin, alleging breach of contract, intentional fraud and misrepresentation, and negligent misrepresentation. Although no specific amount of damages was stated, the complaint alleged that such damages exceeded $5 million. In its answer to the lawsuit, Xerox asserted a counterclaim that Wehr wrongfully withheld payments to Xerox and demanded damages in the amount not yet paid.

Sometime in 1986 while discovery proceeded, a newly appointed Xerox division president visited petitioner in Milwaukee and proposed to settle Wehr's claim for $1.2 million, although he indicated he could go as high as $2 million. This offer was rejected by petitioner.

Throughout the course of the litigation, petitioner, in his capacity as chief executive officer at Wehr, kept the board of directors and Mr. Manegold (who was chairman of the board) informed about the lawsuit as well as the proposed settlement and its rejection. Petitioner also informed Mr. Manegold that he believed Wehr could recover as much as $10 million from Xerox.

Petitioner's Acquisition of Wehr

During the fall of 1986, Mr. Manegold contacted petitioner and inquired whether he was interested in purchasing Wehr's assets. (Apparently, Mr. Manegold anticipated forthcoming changes in the tax laws that made it advantageous for him and his family to sell Wehr prior to the end of 1986.) Mr. Manegold's asking price was in excess of $100 million, which required petitioner to seek financing.

Petitioner spoke with investment banks about assisting in the purchase of Wehr. The investment banks offered to finance the acquisition in exchange for control of Wehr – which petitioner opposed. Throughout the discussions with the investment banks, petitioner informed the bankers of the pending lawsuit because of its impact on cash-flows; the lawsuit also appeared in Wehr's financial reports. Petitioner believed Wehr would

receive between $2 million and $10 million from the lawsuit against Xerox.

Ultimately, petitioner proposed that Mr. Manegold finance the deal as part of a leveraged buy out (in which petitioner would pledge his shares and use the cash-flows from the corporation to repay the debt and interest). In evaluating the financing possibilities, petitioner analyzed Wehr's cash-flow potential, and included the lawsuit against Xerox in that analysis. Mr. Manegold based the $100 million asking price on a multiple of earnings analysis.

On December 30, 1986, petitioner and Mr. Manegold reached an agreement for the acquisition of Wehr. Petitioner organized two S corporations (hereinafter referred together as the S corporations), Venturedyne, Ltd. (Venturedyne), and Carnes Company, Inc. (Carnes), for the purpose of acquiring Wehr. Pursuant to the acquisition agreement, Venturedyne purchased all the assets and assumed all the liabilities of Wehr, other than those related to the Carnes division of Wehr. All the assets and liabilities of the Carnes division of Wehr were acquired and assumed by Carnes. Through 1992, petitioner owned 97.624190 percent of each of the S corporations, and the remainder was owned by Mr. Beda. Since the inception of Venturedyne and Carnes, petitioner has served as the chairman of the board of directors, president, and chief executive officer of both entities.

Following the purchase of Wehr's assets and the assumption of Wehr's liabilities by the S corporations, Wehr was liquidated. The S corporations continued to

operate the same businesses as operated by Wehr prior to its liquidation.

Among the assets acquired by the S corporations were all lawsuits brought by Wehr, including the claim against Xerox. The liabilities assumed by the S corporations included all lawsuits brought against Wehr, including Xerox's counterclaim. Because the parties to the buy out of Wehr did not allocate the purchase price to specific assets, the S corporations engaged two accounting firms to assist in that process. The accounting firms attempted to determine a value for the Xerox lawsuit, but no value was assigned to Wehr's claim against Xerox because the accountants determined that the value of such claim was "too speculative". Thus, no portion of the purchase price for Wehr's assets was allocated to the Xerox lawsuit, and neither of the S corporations booked the lawsuit as an asset. (However, a footnote in the S corporations' audited financial statements identified the existence of the claim against Xerox.) In a Closing Agreement On Final Determination Covering Specific Matters between the S corporations, petitioners, Mr. Beda, and the Commissioner, executed on July 1, 1993, no portion of the purchase price was allocated to the Xerox lawsuit.

The Xerox Lawsuit: Post-1986

Following the buy out of Wehr, the S corporations continued the lawsuit against Xerox in Wehr's name. The primary disagreement of the parties to that lawsuit during the post-1986 period concerned the nature and extent of the damages caused by Xerox's failure to complete the implementation and installation of the computer system.

The parties fought over: (1) Whether Xerox could examine the S corporations' audited financial statements with respect to the issue of lost profits (even though the damages were alleged only with respect to Wehr); (2) whether Wehr could continue to pursue noncontract claims under the so-called economic loss doctrine; (3) whether Wehr had a duty to mitigate damages following the termination of services by Xerox, and if so, when would the computer system project have been completed if it had been continued by Xerox or another party; and (4) whether Wehr could introduce a new method of calculating damages that produced figures ranging from $20 million to more than $120 million in damages.

In late 1992, the District Court ruled that Wehr could introduce evidence as to the new method of calculating damages at trial; immediately thereafter, Xerox sought to settle the lawsuit. Initially, Xerox offered between $2 million and $3 million, but petitioner responded that he would not accept less than $10 million. Xerox indicated that it would go no higher than $6 million, and petitioner's counsel, who believed that Xerox's mitigation argument was a strong one, advised petitioner to accept that amount. The parties eventually agreed to a settlement by which Xerox would pay $5,950,000 in cash and cancel the $395,183 debt owed by Wehr (and assumed by the S corporations) to Xerox, for a total of $6,345,183. The lawsuit was then dismissed with prejudice. The cash payment was made by Xerox on or before December 31, 1992.

Reporting of the Settlement

The S corporations allocated the settlement with Xerox as follows: $3,502,541 to Venturedyne; $2,842,183 to Carnes. The S corporations each reported the settlement as long-term capital gain on their respective 1992 corporate income tax returns. Petitioners similarly reported their allocable share of the settlement ($6,194,437) as long-term capital gain on their 1992 joint income tax return. In calculating the capital gain, neither the S corporations nor petitioners attributed any basis to the lawsuit.

In the notice of deficiency, respondent determined that the settlement proceeds should have been reported as ordinary income.

OPINION

The sole issue for decision herein is whether the proceeds received by the S corporations from the settlement of Wehr's lawsuit against Xerox (the settlement proceeds) should be characterized as ordinary income or long-term capital gain. The resolution of this issue turns on whether the requirements for obtaining capital gain treatment are satisfied, including whether the settlement of Wehr's lawsuit against Xerox constitutes a "sale or exchange".

The parties center their arguments on the "origin of the claim" test to determine whether the settlement proceeds should be characterized as capital gain or ordinary income. See *United States v. Hilton Hotels Corp.*, 397 U.S. 580 (1970); *Woodward v. Commissioner*, 397 U.S. 572 (1970); *United States v. Gilmore*, 372 U.S. 39 (1963); *Gidwitz Family*

Trust v. Commissioner, 61 T.C. 664, 673 (1974); *Keller Street Dev. Co. v. Commissioner*, T.C. Memo. 1973-350, affd. 688 F.2d 675 (9th Cir. 1982). We, however, shall focus our attention on whether the settlement of the lawsuit constitutes a sale or exchange.

A sale or exchange is a prerequisite to the rendering of capital gain treatment. Sec. 1222; *Estate of Nordquist v. Commissioner*, 481 F.2d 1058, 1061 (8th Cir. 1973), affg. T.C. Memo. 1972-198; *Ackerman v. United States*, 335 F.2d 521, 526-527 (5th Cir. 1964); *Breen v. Commissioner*, 328 F.2d 58, 64 (8th Cir. 1964), affg. T.C. Memo. 1962-230. The phrase "sale or exchange" is not defined in section 1222, but we apply the ordinary meaning to those words. *Helvering v. William Flaccus Oak Leather Co.*, 313 U.S. 247, 249 (1941).

It is well established that a compromise or collection of a debt is not considered a sale or exchange of property because no property or property rights passes to the debtor other than the discharge of the obligation. See *Fairbanks v. United States*, 306 U.S. 436 (1939); *National-Standard Co. v. Commissioner*, 749 F.2d 369 (6th Cir. 1984), affg. 80 T.C. 551 (1983); *Osenbach v. Commissioner*, 198 F.2d 235 (4th Cir. 1952), affg. 17 T.C. 797 (1951); *Lee v. Commissioner*, 119 F.2d 946 (7th Cir. 1941), affg. 42 B.T.A. 920 (1940); *Guthrie v. Commissioner*, 42 B.T.A. 696 (1940); *Hale v. Commissioner*, 32 B.T.A. 356 (1935), affd. sub nom. *Hale v. Helvering*, 85 F.2d 819 (D.C. Cir. 1936). In this regard, whatever property or property rights might have existed vanish as a result of the compromise or collection. *Leh v. Commissioner*, 27 T.C. 892, 898 (1957), affd. 260 F.2d 489 (9th Cir. 1958).

On several occasions we have addressed the issue of whether a sale or exchange occurred on the payment of a judgment or the settlement of a claim. See *Towers v. Commissioner*, 24 T.C. 199 (1955), affd. 247 F.2d 233 (2d Cir. 1957); *Hudson v. Commissioner*, 20 T.C. 734 (1953), affd. per curiam sub nom. *Ogilvie v. Commissioner*, 216 F.2d 748 (6th Cir. 1954); *Fahey v. Commissioner*, 16 T.C. 105 (1951). In *Fahey v. Commissioner, supra*, we held that where an attorney was assigned an interest in a contingent lawsuit fee in exchange for a cash payment, settlement of the lawsuit and payment of the fee to the attorney did not give rise to capital gain treatment because no sale or exchange occurred. In reaching our conclusion, we quoted from the opinion of the Court of Appeals for the District of Columbia in *Hale v. Helvering, supra* (relating to the compromise of a note for less than face value):

> There was no acquisition of property by the debtor, no transfer of property to him. Neither business men nor lawyers call the compromise of a note a sale to the maker. In point of law and in legal parlance property in the notes as capital assets was extinguished, not sold. In business parlance the transaction was a settlement and the notes were turned over to the maker, not sold to him. * * *

Fahey v. Commissioner, supra at 109.[2]

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[2] Our reasoning in *Fahey v. Commissioner*, 16 T.C. 105 (1951), was followed by the Court of Appeals for the Fifth Circuit in *Pounds v. United States*, 372 F.2d 342, 349 (5th Cir. 1967), a case relied on by petitioners in support of their argument that the Xerox lawsuit was a capital asset. The *Pounds* court found that no sale or exchange occurred on the payment of a 12½ percent

In *Hudson v. Commissioner, supra,* the taxpayers purchased a 50-percent interest in a judgment from the legatees of an estate, and subsequently the taxpayers settled the judgment with the debtor. The taxpayers reported the payment of the judgment as capital gain. We held that the payment should be characterized as ordinary income, explaining:

> We cannot see how there was a transfer of property, or how the judgment debtor acquired property as the result of the transaction wherein the judgment was settled. The most that can be said is that the judgment debtor paid a debt or extinguished a claim so as to preclude the execution on the judgment outstanding against him. In a hypothetical case, if the judgment had been transferred to someone other than the judgment debtor, the property transferred would still be in existence after the transaction was completed. However, as it actually happened, when the judgment debtor settled the judgment, the claim arising from the judgment was extinguished without the transfer of any property or property right to the judgment debtor. In their day-to-day transactions, neither businessmen nor lawyers would call the settlement of a judgment a sale; we can see no reason to apply a strained interpretation to the transaction before us. When petitioners received the $21,150 in full settlement of the judgment, they did not recover the money as a result of any sale

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profit interest in a land deal because following the transaction only one party, the taxpayer, received property (the cash payment).

> or exchange but only as a collection or settlement of the judgment.

Id. at 736.

Despite these and other similar cases[3], petitioners contend that the passing of property or property rights to the debtor is not relevant in determining whether a sale or exchange occurred. In support of this argument, petitioners direct us to *Commissioner v. Ferrer*, 304 F.2d 125 (2d Cir. 1962), revg. in part and remanding 35 T.C. 617 (1961). In *Ferrer*, the taxpayer acquired from an author the right to produce a play (based on the author's book) which included the right to prevent the author's transfer of film rights. Subsequently, the taxpayer surrendered his rights (the "lease") in exchange for the leading role in a film production. The issue arose as to whether the surrendering of the taxpayer's rights constituted a sale or exchange for purposes of the capital gain provisions. In holding that a sale or exchange of the surrendered lease occurred, the Court of Appeals for the Second Circuit stated that Congress was disenchanted with the "formalistic distinction" between a sale of property rights to third parties (which would give rise to capital gain or loss) and the release of those rights that results in their extinguishment (and which would not give rise to capital gain or loss). The court continued:

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[3] The Court of Appeals for the Seventh Circuit, the court to which an appeal in this case lies, has distinguished sales or exchanges from collections and other transactions in which no property or property rights survive. See *Chamberlin v. Commissioner*, 286 F.2d 850, 852 (7th Cir. 1960), affg. 32 T.C. 1098 (1959); *Lee v. Commissioner*, 119 F.2d 946, 948 (7th Cir. 1941), affg. 42 B.T.A. 920 (1940).

> In the instant case we can see no sensible business basis for drawing a line between a release of Ferrer's rights * * * and a sale of them * * * . * * * Tax law is concerned with the substance, here the voluntary passing of "property" rights allegedly constituting "capital assets," not with whether they are passed to a stranger or to a person already having a larger "estate." * * *

Id. at 131.

Petitioners have misread *Ferrer* and its import. *Ferrer* (and the cases cited therein) can be factually distinguished from the instant case because in *Ferrer* the taxpayer's interest (or lease) to produce the play and prevent the author's transfer of film rights did not disappear but instead reverted to the author after the taxpayer surrendered the lease; whereas in the instant case, the S corporations' rights in the lawsuit vanished both in form and substance upon the receipt of the settlement proceeds.

In the case herein, the S corporations and Xerox settled the lawsuit originally brought by Wehr. The S corporations received consideration of $6,345,183; Xerox received nothing other than the discharge of the liability that arose as the result of the lawsuit. We find no discernible distinction between the situation herein and the situations discussed in *Fahey v. Commissioner, supra,* or *Hudson v. Commissioner, supra.* In each case, the debtor made payment to the creditor or an assignee of the original creditor in exchange for the extinguishment of the claim. Whether the claim is reduced to judgment before payment is not relevant; ultimately the debtor receives

nothing in the form of property or property rights which can later be transferred. Consequently, we hold that the settlement of the lawsuit between the S corporations and Xerox does not constitute a sale or exchange and hence capital gain treatment is not warranted.

Petitioners argue that the so-called *Arrowsmith* doctrine requires us to apply capital gain treatment to the settlement claim regardless of whether a sale or exchange occurred. We disagree. In *Arrowsmith v. Commissioner,* 344 U.S. 6 (1952), the Supreme Court held that the characterization of a transaction may require examination of prior, related transactions. In *Arrowsmith,* the taxpayer-shareholders reported as capital gain the gain realized on the liquidation of their corporation. Subsequently, a judgment was rendered against the former corporation, and the shareholders, as transferees of the corporation's assets, paid the judgment. The Supreme Court held that the payment of the judgment resulted in a capital (rather than ordinary) loss because the judgment was inextricably related to the capital gain which resulted from the liquidation.

Here, petitioners assert that the receipt of the settlement proceeds is related to a prior transaction, namely the acquisition of Wehr's assets, citing *Bresler v. Commissioner,* 65 T.C. 182 (1975). In *Bresler,* the shareholder of an S corporation sought to treat the proceeds from the settlement of an antitrust lawsuit as capital gain, asserting that the settlement was intended to compensate the taxpayer for losses that resulted from the earlier sale of certain properties. We rejected that argument because the earlier sale of the properties resulted in ordinary losses under section 1231, and thus under *Arrowsmith v. Commissioner,*

supra, the settlement proceeds constituted ordinary income.

Petitioners have misapplied the rationale of *Arrowsmith* and its progeny, including *Bresler*, to the situation herein. The acquisition of Wehr's assets was not the basis for the lawsuit against Xerox, and the settlement in favor of the S corporations was not related to the leveraged buy out. Cf. *West v. Commissioner*, 37 T.C. 684, 687 (1962). The origin of the claim in this case was Xerox's breach of contract, as detailed in the complaint filed by Wehr in the District Court. The treatment of the settlement proceeds as ordinary income or capital gain is not dependent on the fact that the S corporations acquired Wehr's assets in a capital transaction.[4] As such, the *Arrowsmith* doctrine is inapplicable.

We have considered all of petitioners' other arguments and find them to be not relevant or without merit.

In conclusion, we hold that the settlement of the Xerox lawsuit did not constitute a sale or exchange; consequently, the settlement proceeds constitute ordinary income, not capital gain, to petitioners. Inasmuch as petitioners allocated no part of the purchase price for Wehr's assets to the Xerox lawsuit, they acquired no basis in the

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[4] As stated in *Fahey v. Commissioner*, 16 T.C. at 108, and reiterated in *Pounds v. United States*, 372 F.2d at 349, the mere occurrence of a sale or exchange of the subject asset at some point in time is not sufficient to obtain capital gain treatment on a later disposition. The sale or exchange must be proximate to the event which gave rise to the gain.

lawsuit. Thus, the entire settlement proceeds are includable in gross income.

To reflect the foregoing,

Decision will be entered for respondent.

United States Court of Appeals

For the Seventh Circuit
Chicago, Illinois 60604

January 28, 2000

Before

Hon. Richard A. Posner, *Chief Judge*

Hon. Richard D. Cudahy, *Circuit Judge*

Hon. Michael S. Kanne, *Circuit Judge*

No. 99-1149

BRIAN L. NAHEY AND CAROL J. NAHEY,
Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Appeal from the United States Tax Court.

ORDER

On December 30, 1999, petitioners-appellants filed a petition for rehearing and petition for rehearing *en banc*. All the judges on the original panel have voted to deny the petition, and none of the active judges has requested a vote on the petition for rehearing *en banc*. The petition is therefore **DENIED.**

SEC. 1222. OTHER TERMS RELATING TO CAPITAL GAINS AND LOSSES.

For purposes of this subtitle –

1222(1) SHORT-TERM CAPITAL GAIN. – The term "Short-term capital gain" means gain from the sale or exchange of a capital asset held for not more than 1 year, if and to the extent such gain is taken into account in computing gross income.

1222(2) SHORT-TERM CAPITAL LOSS. – The term "short-term capital loss" means loss from the sale or exchange of a capital asset held for not more than 1 year, if and to the extent that such loss is taken in to account in computing taxable income.

1222(3) LONG-TERM CAPITAL GAIN. – The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 1 year, if and to the extent such gain is taken into account in computing gross income.

1222(4) LONG-TERM CAPITAL LOSS. – The term "long-term capital loss" means loss from the sale or exchange of a capital asset held for more than 1 year, if and to the extent that such loss is taken into account in computing taxable income.

1222(5) NET SHORT-TERM CAPITAL GAIN. – The term "net short-term capital gain" means the excess of short-term capital gains for the taxable year over the short-term capital losses for such year.

1222(6) NET SHORT-TERM CAPITAL LOSS. – The term "net short-term capital loss" means the excess of short-term capital losses for the taxable year over the short-term capital gains for such year.

1222(7) NET LONG-TERM CAPITAL GAIN. – The term "net long-term capital gain" means the excess of

long-term capital gains for the taxable year over the long-term capital losses for such year.

1222(8) NET LONG-TERM CAPITAL LOSS. – The term "net long-term capital loss" means the excess of long-term capital losses for the taxable year over the long-term capital gains for such year.

1222(9) CAPITAL GAIN NET INCOME. – The term "capital gain net income" means the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges.

1222(10) NET CAPITAL LOSS. – The term "net capital loss" means the excess of the losses from the sales or exchanges of capital assets over the sum allowed under *section 1211*. In the case of a corporation, for the purpose of determining losses under this paragraph, amounts which are short-term capital losses under *section 1212* shall be excluded.

1222(11) NET CAPITAL GAIN. – The term "net capital gain" means the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year.

For purposes of this subtitle, in the case of futures transactions in any commodity subject to the rules of a board of trade or commodity exchange, the length of the holding period taken into account under this section or under any other section amended by section 1402 of the Tax Reform Act of 1976 shall be determined without regard to the amendments made by subsections (a) and (b) of such section 1402.

Internal Revenue Service

Date: MAR 15 1996

CERTIFIED MAIL

Brian L. Nahey and
Carole L. Nahey
5661 North Hwy 83
Hartland, WI 53029

Department of the Treasury

Taxpayer Identification Number: 399-42-5182
Form:
1040
Tax Year Ended and Deficiency:

See attached
Notice of Deficiency - Waiver

Person to Contact:
Vernon L. Los
Telephone Number:
(414) 297-4230

Dear Mr. and Mrs. Nahey:

NOTICE OF DEFICIENCY

We determined that you owe an additional amount, as shown above. This letter is your NOTICE OF DEFICIENCY as required by law. The enclosed statement shows how we figured the deficiency.

If you want to contest this deficiency in court before making any payment, you have 90 days from the above mailing date of this letter (150 days if addressed to you outside the United States) to file a petition with the United States Tax Court for a redetermination of the deficiency. To get a petition form and the rules for filing a petition, write to: United States Tax Court, 400 Second Street, NW, Washington, D.C. 20217.

Send the completed petition form, a copy of this letter, and a copy of all statements and schedules you received with this letter to the Tax Court at the same address.

The time you have to file a petition with the Court (90 or 150 days) is fixed by law. The court cannot consider your case if you file the petition late.

If this letter is addressed to both **husband and wife**, and both want to petition the Tax Court, **both must sign and file the petition** or each must file a separate, signed petition. If only one of you petitions the Tax Court, the full amount of the deficiency will be assessed against the non-petitioning spouse.

Small Tax Cases

The Tax Court has a simplified procedure for small tax cases, when the amount in dispute is $10,000 or less for any one tax year. You can get information about this procedure, as well as a petition form, by writing to the Clerk of the United States Tax Court at the court address shown in the second paragraph above. You should write promptly if you intend to file a petition with the court.

If you decide not to file a petition with the Tax Court, please sign and return the enclosed waiver form. This will permit us to assess the deficiency quickly and will limit the accumulation of interest. The enclosed envelope is for your convenience.

If you are a C corporation, under Internal Revenue Code Section 6621(c), large corporate underpayments

may be subject to a higher rate of interest than the normal rate of interest for underpayments.

If you decide not to sign and return the waiver, and you don't file a petition with the Tax Court within the time limit, the law requires us to assess and bill you for the deficiency after 90 days from the above mailing late (150 days if this letter is addressed to you outside the United States).

If you have any questions about this letter, you may call or write to the person whose name is shown above. If the telephone number is outside your local calling area, you will be charged for a long distance call. If you write, please attach a copy of this letter to help us identify your account. Also, include your daytime telephone number so we can call you if necessary.

Sincerely,

MARGARET MILNER
RICHARDSON
Commissioner
by
/s/ Timothy I. Gukich
Timothy I. Gukich
Associate Chief, Appeals

Enclosures
Copy of this letter
Statement
Waiver
Envelope

cc: Robert Schnur

Form 4089
(Rev. January 1983)

Department of the Treasury – Internal Revenue Service

Notice of Deficiency-Waiver

Symbols
MAR 15 1996
AP:MIL:VLL:JLP

Name, SSN or EIN, and Address of Taxpayer(s)

Brian L. Nahey (SSN: 399-42-5182) and
Carole L. Nahey (SSN: 394-42-3299)
5661 North Hwy 83
Hartland, WI 53029

Kind of Tax
Income

[X] Copy to Authorized Representative
Robert Schnur

Tax Year Ended
December 31, 1992

Deficiency

Increase in Tax	**Penalties**
$185,833.00	

See the attached explanation for the above deficiencies

I consent to the immediate assessment and collection of the deficiencies (increase in tax and penalties) shown above, plus any interest provided by law.

Your
Signature ➤ _____

(Date signed)

Spouse's Signautre, [sic]
If A Joint Return
Was Filed ➤ _____
(Date signed)

Taxpayer's
Representative
Sign Here ➤ _____
(Date signed)

Corporate
Name: _____

Corporate ➤ _____
Officers *(Signature) (Title) (Date signed)*
Sign Here ➤ _____
(Signature) (Title) (Date signed)

Note:

If you consent to the assessment of the amounts shown in this waiver, please sign and return it in order to limit the accumulation of interest and expedite our bill to you. Your consent will not prevent you from filing a claim for refund (after you have paid the tax) if you later believe you are entitled to a refund. It will not prevent us from later determining, if necessary, that you owe additional tax; nor will it extend the time provided by law for either action.

If you later file a claim and the Internal Revenue Service disallows it, you may file suit for refund in a district court or in the United States Claims Court, but you may not file a petition with the United States Tax Court.

Who Must Sign

If this waiver is for any year(s) for which you filed a joint return, both you and your spouse must sign the original and duplicate of this form. Sign your name exactly as it appears on the return. If you are acting under power of attorney for your spouse, you may sign as agent for him or her.

For an agent or attorney acting under a power of attorney, a power of attorney must be sent with this form if not previously filed.

For a person acting in a fiduciary capacity (executor, administrator, trustee), file Form 56, Notice Concerning Fiduciary Relationship, with this form if not previously filed.

For a corporation, enter the name of the corporation followed by the signature and title of the officer(s) authorized to sign.

FORM 4549-A
REV 7/81

Schedule 1

DEPT. OF THE TREASURY – INTERNAL REVENUE SERVICE
INCOME TAX EXAMINATION CHANGES

Name and Address of Taxpayers	SSN 399-42-5182	Filing Status
Brian L. & Carole L. Nahey		Married Joint
5661 North Hwy 83	Person With Whom Changes Were Discussed	
Hartland, WI 53029		

		YEAR: 1992	YEAR:
1.	ADJUSTMENTS TO INCOME:		
	A. Net Long-Term Capital Gain	(6,194,437.00)	
	B. Ordinary Income	6,194,437.00	
	C.		
	D.		
	E.		
	F.		
	G.		
2.	TOTAL ADJUSTMENTS	0.00	0.00
3.	TAXABLE INCOME SHOWN ON RETURN	7,011,977.00	
4.	CORRECTED TAXABLE INCOME	7,011,977.00	0.00
5.	TAX	2,165,550.00	
6.	ALTERNATIVE TAX, IF APPLICABLE		

7.	CORRECTED TAX LIABILITY	2,165,550.00	0.00
8.	LESS: CREDITS:		
	A. INVESTMENT TAX CREDIT (Page ___)		
	B. other credits		
	C.		
9.	BALANCE	2,165,550.00	0.00
10.	PLUS:		
	A. SELF-EMPLOYMENT TAX		
	B. MINIMUM TAX (Page ___)		
	C.		
11.	TOTAL CORRECTED TAX LIABILITY	2,165,550.00	0.00
12.	TOTAL TAX shown on return	1,979,717.00	
13.	DEFICIENCY (line 12-line 13)	185,833.00	0.00
14.	OVERASSESSMENT (line 13-line 12)		
15.	Adjustment to Prepayment Credits		
16.	BALANCE DUE, Not including interest	185,833.00	0.00
17.	OVERPAYMENT, Not including interest		
18.	PENALTIES, IF ANY (see explanation)		

Other Information

Schedule 1-A

YEAR ENDED
December 31, 1992

Brian L. & Carole L. Nahey

	Capital Gain Reported As Capital Gain	K-1 Share for B & C Nahey
Venturedyne, Ltd. 1120S	3,502,541	3,419,327
Carnes Company, Inc. 1120S	2,842,642	2,775,106
	6,345,183	6,194,433

The amount of 6,194,433 was reported by Mr. Nahey as long term capital gain. As per the report included under Venturedyne, Ltd., the amount should have been reported as ordinary income. The adjustment is being made here and is reflected on the form 4549A. The additional tax is due to the capital gain rate of 28%. The amount was properly spread between Mr. Nahey and the other shareholder.

Brian L. & Carole L. Nahey — Schedule 2

YEAR ENDED
December 31, 1992

TAX COMPUTATION USING MAXIMUM CAPITAL GAINS RATE

1.	Amount from Form 1040 line 37, Taxable Income	7,011,977
2.	Net Long-Term Capital Gain As Corrected	30,450
3.	Subtract line 2 from line 1	6,981,527
4.	Enter 35,800 for Married Filing Joint	35,800
5.	Greater line 3 or 4	6,981,527
6.	Subtract line 5 from line 1	30,450
7.	Tax on line 5 – Tax Rate Schedules	2,157,024
8.	Multiply line 6 by 28%	8,526
9.	Tax – Add lines 7 & 8	2,165,550

Tax Per Return	1,979,717
Corrected Tax Above	2,165,550
Additional Tax Due	185,833